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M&A Terms in Pandemic-Affected Market

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EXECUTIVE SUMMARY

The COVID-19 outbreak has severely impacted the world economy and will likely continue to do so for a prolonged period of time. As virtually every country in the world has, on some level, instituted lockdowns and orders that people shelter at home, consumer spending has fallen sharply. Many industries are experiencing significant business disruptions, including supply chain problems, decreases in demand and mass workforce layoffs or furloughs. The virus has also put many ongoing M&A transactions on hold and put a brake on companies' intentions to pursue future deals. We anticipate that the current recession may result in fewer buyers, as many smaller and mid-sized acquirors will be focused on stabilizing cash flow and will not have the necessary resources to pursue acquisitions. However, we expect cash-rich or larger buyers with access to cash to become more aggressive in pursuing deals and taking advantage of lower valuations that may result from the current economic downturn. Because we anticipate that the current pandemic will result in fewer buyers overall, we speculate that there may be a shift from an extended period of a sellers' market to a market that, to some degree, will be more buyer-friendly and, consequently, those cash-rich buyers left in the market will likely attempt to allocate greater deal risks onto sellers. Below are some of the principal issues we expect buyers and sellers to re-evaluate in a market affected by COVID-19.

VALUATION AND PURCHASE PRICE ADJUSTMENT

The economic shock caused by the COVID-19 pandemic will drive down corporate valuations that are based on historical financial performance. If fewer buyers are ready or able to enter the M&A market, valuations are likely to fall even further. These sudden changes in the financial and M&A markets will likely lead to more disagreements with respect to valuations of target companies and, therefore, increased use of earn-out provisions. However, using earn-outs increases the potential for post-closing disputes and therefore should be used with caution. We may also expect buyers to request larger purchase price adjustment escrows and the inclusion of purchase price adjustments based on factors other than working capital (the most common adjustment metric), such as revenues and earnings.

MATERIAL ADVERSE EFFECT & BUYER TERMINATION RIGHTS

The market definition of "Material Adverse Effect" ("MAE"), commonly used in definitive agreements, may also be impacted. In many purchase agreements, certain of the parties' representations and warranties are qualified such that they would not be implicated if a breach of any such representation or warranty would not likely result in an MAE. Many purchase agreements also include a condition to buyer's obligation to close that no MAE with respect to the target has occurred. These types of MAE provisions are a critical means by which the parties allocate different types of risk among themselves. A typical MAE clause allocates systemic risks to a buyer by excluding certain events that are out of the seller's control from an MAE definition. These events often include general economic or political conditions, changes in financial or securities markets in general, events of war and/or terrorism, etc. A typical MAE definition will also include an exception to these exclusions to the extent such exclusions have had disproportionate effects on the target company compared to other applicable companies (for example, other participants in the industries in which the target company operates).

Historically, it has been difficult to successfully invoke an existence of an MAE and terminate a transaction, and attempting to do so would almost certainly lead to litigation. Currently, under Delaware law (which is a leading state for corporate law in the U.S.), there has been only one judicial decision (*Akorn v. Fresenius Kabi AG*[1]) which has found that a buyer was justified in terminating a transaction by claiming that an MAE had occurred. Even during the 2008 financial crisis, no Delaware courts ruled that a party's decision to terminate an agreement on the basis of an MAE was justified; however, it is commonly acknowledged that most disputes about terminating a contract on this basis are settled privately out-of-court. In *Akorn*, the court reiterated that an MAE must "substantially threaten the overall earnings potential of the target in a durationally significant manner." The MAE standard has proven to be a very high standard.[2] It is unclear how Delaware courts will analyze the COVID-19 pandemic in relation to an existence of an MAE, but we expect to see further developments in the course of time.

In the seller-friendly market that existed prior to the pandemic, purchase agreements commonly defined an MAE as "an event or occurrence that resulted in a material adverse effect on the business, results of operations, financial condition or assets of the target company." Buyers would attempt to expand the definition such that an MAE could occur if there was a material adverse effect on the "prospects" of the target, but this was rarely accepted due to its forward-looking nature. However, if the M&A market adjusts to favor buyers, more buyers may attempt to include the word "prospects" in the definition of MAE. This inclusion will give buyers broader arguments for an event, condition, or change to constitute an MAE. Also, as a result of COVID-19, sellers will likely attempt to include in the definition of MAE the word "pandemic" (or specifically "COVID-19") as an exclusion to an MAE. At least until there is some reasonable visibility as to the timing for the end of the COVID-19 outbreak, buyers with leverage may resist the inclusion of this carve out. Lastly, case law suggests that buyers will have a much better chance of proving an MAE if the parties can agree to an objective trigger for an MAE (for example, including a specific amount in which the target's earnings fall). Because of the difficulty in agreeing to a specific trigger for an MAE (especially a financial threshold) at the time of signing of the purchase agreement, such objective test for proving an MAE normally has not been included. But we may see changes to this practice if the market shifts to a more buyer-favorable market.

Parties can, alternatively, agree to include objective thresholds to trigger a buyer's specific termination rights. These may include a buyer's right to terminate the transaction if any of the following (with respect to the target company's business) occurs:

- a fall in profits or earnings over a specific percentage threshold;
- an interruption to a key supply chain;
- a loss of orders or "Major Customers";
- a termination of certain material contracts;
- a key employee resignation;
- a workforce reduction over a specific % threshold; and
- the issuance of government order which results in closure of business operations.

The above-mentioned termination rights are pro-buyer terms that would be often resisted by sellers. However, the outcome of a negotiation of these terms may be different during the current business environment.

COVID-19 RELATED REPRESENTATIONS AND WARRANTIES

As long as the effect of COVID-19 on businesses continues to be uncertain, we expect buyers to shift COVID-19 related risks by attempting to include certain market and pandemic-driven representations and warranties. Buyers may require sellers to represent and warrant that there have been no government orders or the like which impose restrictions on operations of the target's critical customers and critical suppliers. Additionally, purchase agreements usually contain standard representations regarding the continuity of relationships with critical customers and critical suppliers; but, in addition, buyers may include broader representations addressing a target's supply chain (as opposed to merely critical suppliers). For example, a buyer may require inclusion of a seller's representation that no "material supplier or vendor in the supply chain" has delayed deliveries or declared force majeure or defaulted, and that none of such parties' operations have been ordered to close by a government in connection with a pandemic. A buyer should also likely require a seller's representation regarding compliance with specific COVID-19-related regulations. Finally, representations with respect to business interruption insurance and continuity and emergency preparedness may become more common.

INTERIM OPERATING COVENANTS

In light of the changed economic conditions, the parties should revisit the commonly-used term "ordinary course of business" as a requirement for operations between the signing of the purchase agreement and closing (and similarly as a closing condition). As such term would be strictly construed, practically no businesses are operating in the "ordinary course" during the current pandemic. We may see efforts by sellers to exclude COVID-19 related accommodations from this concept, but buyers will likely resist this. The current business environment will also likely require parties (and later, courts) to determine what efforts meet the commonly-included requirement that the target has used "commercially reasonable" efforts to comply with various covenants during the COVID-19 crisis and what actions are not required. Parties should also consider including an interim covenant that would require the parties to cooperate with each other with respect to any COVID-19 related issues.

REGULATORY APPROVAL

Because many government agencies are operating with limited staffing or may be focused on other activities, we expect delays in obtaining required regulatory approvals (whether it be approvals with respect to HSR filing, CFIUS declaration or notice, etc.) in the current environment. Related to this, sellers may push for an extension of what is commonly called a "drop dead date," which is the date after which a buyer may terminate a transaction if it has not closed, or they may see more flexibility in pushing off the closing date. Buyers are likely to want the ability to walk away if a regulatory approval will significantly delay a closing.

R&W INSURANCE

Prior to the COVID-19 outbreak, representation and warranty insurance was being used for a broader range of deals to manage the risk of breaches, including deals with lower transaction values. However, representation and warranty insurance providers are expected to make adjustments to their terms and the scope of their coverage to exclude some matters arising out of the current pandemic, and these exclusions could affect the perception of the value of these policies among market participants. This is an area that continues to develop, and we continue to closely monitor such developments.

OTHER PROVISIONS

The market may see an increase in other buyer-favorable terms. For example, we may see (a) more transactions occurring by way of asset purchases (as opposed to purchases of equity interests), (b) the inclusion of pro-sandbagging provisions (even in agreements governed under laws of a pro-sandbagging jurisdiction), (c) guarantees being required from the ultimate shareholder of a target company, (d) broader seller indemnification provisions or double materiality scrapes. We also expect buyers to ask for longer warranty survival periods and higher indemnification escrow amounts. Finally, we also expect to see buyers demand higher caps and lower basket and deductible amounts with respect to indemnification protections being offered by sellers.

How COVID-19 will impact the parties will differ deal-by-deal and will be based on the specific target's business operations. But we anticipate a change in what terms will be considered "market." There likely will be recurring issues and terms that may arise in transactions during the COVID-19 business environment and the parties should carefully assess these issues and potential solutions to those problems.

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[1] *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), aff'd, 2018 WL 6427137 (Del. Dec. 7, 2018)

[2] *See e.g., In re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001) (holding that a large decline in earning, 64%, for one quarter was not material due to lack of durational significance); *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008) (holding that a 3% decline in 2007 EBITDA from the prior year, and projected 7% (or 11% using conservative projections) decline in EBITDA for the next year, did not give rise to an MAE).